

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF THE PENDLETON)	
COUNTY WATER DISTRICT, OF PENDLETON)	
AND CAMPBELL COUNTIES, KENTUCKY FOR)	CASE NO. 9625
APPROVAL OF CONSTRUCTION, FINANCING)	
AND INCREASED RATES)	

O R D E R

Pendleton County Water District ("Pendleton") by application filed July 3, 1986, and revised during the proceedings in this matter, is seeking approval of adjustments to its water service rates, authorization to construct a \$1,032,750 waterworks improvement project, approval of its plan of financing for this project and the incorporation of Case No. 9328 herein by reference. The project funding includes a \$273,000 loan from the Farmers Home Administration ("FmHA"), a \$727,000 grant from the FmHA and contributions of \$32,750 from applicants for service in the proposed project area. The FmHA loan will be secured by waterworks revenue bonds maturing over a 40-year period at an interest rate of 6 5/8 percent per annum.

The proposed construction will be capable of providing water service to 131 new customers. Drawings and specifications for the proposed improvements by Proctor/Davis/Ray, Architects, Engineers, Planners of Lexington, Kentucky, ("Proctor/Davis/Ray") have been approved by the Division of Water of the Natural Resources and Environmental Protection Cabinet.

The rates proposed by Pendleton and revised during the proceedings would produce additional revenue of \$127,307, an increase of 80.34 percent over adjusted and normalized operating revenue of \$158,463, which includes the proposed 131 additional customers. Based upon the determination herein, the operating revenue of Pendleton will increase by \$95,909 annually over adjusted and normalized test-year operating revenue, an increase of 60.52 percent.

On April 22, 1986, Griffin Industries, Inc., ("Griffin") filed a complaint with the Commission against Pendleton (Case No. 9593) stating that it had been overcharged for water service since 1981, and therefore had requested that Pendleton make certain adjustments in its minimum usage allowance.

On June 10, 1986, Pendleton responded to Griffin's complaint denying that it had been overcharging Griffin and further requested that Griffin's complaint be either dismissed or merged into Pendleton's rate case proceeding. For hearing purposes only, the Commission consolidated this instant case with Case No. 9593.

A hearing was held in the offices of the Public Service Commission, in Frankfort, Kentucky, on February 3, 1987. Griffin intervened in this matter.

As the hearing closed, Pendleton was directed to file certain items of additional information. This information has been filed and the matter is considered to be fully submitted for final determination by the Commission.

Staff Audit Report

To simplify the regulatory process for this utility, the Commission staff performed a limited financial audit for the utility's test year to verify reported expenditures and substantiate the propriety of the test-year financial statements. The staff report was made part of the record in this case as an appendix to the Commission's Order of November 20, 1986.

On December 29, 1986, Pendleton filed a response to the staff report. The staff report issued by the Commission showed test year revenue from Division I and Division II as \$146,712. The normalized test year revenue per the billing analysis contained in the staff report is \$155,019. In its response, Pendleton noted that Pendleton County High School ("High School") used 680,000 gallons during the test year instead of the 1,203,000 gallons shown in the staff's billing analysis. In discussing this matter with Pendleton, it was determined that the computer printout used in preparing the billing analysis contained an erroneous gallonage amount for the High School for the month of December. Test-year normalized revenue has been decreased by \$1,162 to reflect this adjustment in gallons sold.

Pendleton also noted that the staff's billing analysis included actual test year sales to Griffin, whereas the actual sales, based upon the settlement agreement between Pendleton and Griffin, will be 4.8 million gallons annually. Test-year normalized revenue has been decreased by \$25,954 to reflect the decreased sales to Griffin.

In addition, Pendleton stated in its response to the staff audit report that it is unable to reconcile the additional revenue figures of \$127,000 referred to on page 1 and the \$121,791 referred to on page 2 of the audit report. The difference of \$5,209 can be partially attributed to the erroneous gallonage amount used in calculating the revenue from the High School. The remainder can be attributed to the fact that the staff used an actual 12-month test year while Pendleton's calculations are taken from a 6-month period and annualized. Therefore, due to the aforementioned adjustments, the test-year normalized operating revenue from water sales per the staff report has been decreased by \$27,116.

The financial statement contained in the staff report, adjusted to reflect the aforementioned issues, has been used as the basis for determining the rate increase.

RATE DESIGN

Pendleton currently has separate rate schedules for Division I and Division II. In its application, Pendleton and FmHA proposed to combine the rates paid by customers in Divisions I and II. After reviewing Pendleton's application and the staff's billing analysis the Commission has determined that combining the rates is fair, just, and reasonable and should be approved.

Pendleton proposed to reduce the monthly minimum usage allowance for Griffin from 1.2 million to 400,000 gallons. Pendleton also proposed to reduce the monthly minimum usage allowance for the High School from 150,000 gallons to 125,000 gallons.

After reviewing the usage patterns of these customers the Commission is of the opinion that the proposed minimums more adequately reflect the actual usage levels and should therefore be approved.

REVENUES AND EXPENSES

Pendleton proposed, and the Commission accepts, the 12-month period ending December 31, 1985, as an appropriate test period for determining the reasonableness of the proposed rates.

Pendleton revised its application several times during the proceedings. The last revision, filed at the hearing on February 3, 1986, has been used by the Commission as the basis for determining Pendleton's total revenue requirements.

Pendleton proposed several adjustments in the last revision to the test period revenues and expenses per the staff report, which are generally proper and acceptable for rate-making purposes, with the following modifications:

Operating Revenues from Metered Sales

Pendleton based its application on 130 customers to be served by the Phase III expansion. Pendleton stated at the hearing that 131 customers would be served by the expansion. Therefore, test-year normalized operating revenue has been increased by \$30,560 to reflect the 131 additional customers.

Due to the preceding discussion of the response to the staff report, normalized test-year operating revenues per the staff report of \$155,019 were decreased by \$27,116. Based on the aforementioned adjustments the test-year operating revenue per the staff report has been increased to \$158,463.

Purchased Water Expense

Pendleton's actual purchased water expense for the test year was \$66,547. Pendleton proposed to increase the test year expense by \$11,189 due to an increase in the rates of one of its suppliers, Campbell County Water District ("Campbell"), effective December 29, 1986, and the estimated increase in water purchased due to the 131 additional customers.

The Commission is of the opinion that the acceptable line loss percentage should be limited to 15 percent for most water utilities. Pendleton incurred line loss of approximately 30 percent during the test year. The Commission has determined the allowed purchased water expense for rate-making purposes to be \$71,261 based upon Campbell's current rates, a 15 percent allowed line loss, and 131 additional customers. Thus, the purchased water expense has been increased by \$4,714.

Power Purchased Expense

Per the staff report, Pendleton's power purchased expense was \$5,933. Pendleton proposed a \$1,253 increase to the account due to the rate increase of Harrison County Rural Electric Cooperative Corporation ("Harrison") effective in April 1986, the percentage increase in gallons pumped based upon Griffin's reduced usage and the additional customers, and elimination of the sales tax previously charged on Harrison's invoices. This adjustment has been recalculated using the same method but with more accurate figures on the gallons sold resulting in an adjustment of \$1,539. Therefore, the purchased power expense has been increased by \$1,539 to \$7,472.

Outside Services Employed

Per the staff report, Pendleton's outside services employed expense for the test period was \$2,082. Pendleton proposed to increase this amount by \$6,933 due to the annual audit fee of Allen, England and Hensley, Certified Public Accountants, and amortizing over 3 years the legal expenses associated with the City of Falmouth and Griffin disputes.

The Commission is of the opinion that inclusion of the \$4,500 annual audit fee is reasonable but that the \$1,500 audit fee paid to Ted Monroe, Certified Public Accountant, during the test year should be excluded as only one audit will be performed per year. The Commission examined the legal invoices outside the test period from Stites and Harbison, and the expenses associated with the City of Falmouth and Griffin disputes total \$6,177. The Commission agrees with Pendleton that these expenses are not normal operating expenses and, thus, should be amortized over a 3-year period resulting in a \$2,059 amortization expense.

Pendleton did not include in the revised application the test year expenses totaling \$1,506 associated with the Cotton and Allen audit performed at the Commission's request, and the Griffin dispute which were included and amortized over 3 years in the staff report. The Commission is of the opinion that the \$502 amortization expense should be included in the outside services employed expense. Therefore, due to the aforementioned adjustments, the outside services employed expense has been increased by \$5,561.

Office Supplies and Expenses

Pendleton's test-year office supplies and expenses totaled \$2,207. Pendleton proposed to increase this expense by \$463 due to the percentage increase in additional customers from the proposed extension.

The office supplies and expenses account includes a monthly office rental fee of \$57.75, postage expense, and miscellaneous items. The Commission is of the opinion that the office supplies and expenses will increase due to the additional customers, but the rent expense portion of the account will not. Therefore, the Commission excluded the test-year rent expense of \$693 before determining the adjustment based upon a 21.51 percent increase in customers. This adjustment results in a \$326 increase to office supplies and expenses.

Regulatory Commission Expense

Per the staff report, rate case expenses totaling \$2,599 were capitalized and amortized over 3 years resulting in test-year regulatory commission expense of \$866. Pendleton proposed to increase this expense by \$4,433 based upon amortization over 3 years of legal services of \$5,500, engineering services of \$6,000, and accounting fees of \$1,800.

Based upon copies of invoices provided to the Commission, the legal expenses associated with the rate case incurred outside the test period total \$6,488. Proctor/Davis/Ray performed a rate case study for Pendleton at a cost of \$6,139. This study contained the determination of the proposed rates based upon Pendleton's records and pro forma adjustments. As stated previously, this rate case

study has been revised several times during the proceedings in this matter. Per the invoices submitted, Proctor/Davis/Ray billed Pendleton the direct salaries of the personnel working on the case, plus an overhead charge of 1.4 times the direct salaries expense, plus a 17 percent profit on the total salaries expense and overhead charge, and any incurred expenses. The Commission is of the opinion that the resulting 180 percent increase of the direct salaries expense charged by Proctor/Davis/Ray is excessive when considering the actual content of the final revision of the rate case study filed at the hearing. Therefore, the Commission is of the opinion that only the direct salaries expense and the incurred expenses totaling \$2,217 should be allowed for rate-making purposes.

The Commission agrees with Pendleton that the expenses associated with the rate case should be amortized over 3 years to reflect normal operating conditions. Therefore, the regulatory commission expense has been increased by \$3,502 to reflect the amortization of the \$6,488 of legal fees, \$2,217 of allowed engineering expenses and \$1,800 of accounting services.

Depreciation Expense

Pendleton reported depreciation expense of \$29,680 for the test year. Pendleton proposed to increase the test-year depreciation expense by \$22,648 due to the extension based upon the actual construction costs of \$788,580. The Commission is of the opinion that the total cost of the extension exclusive of the costs for land and land rights-of-way should be capitalized. Therefore, the projected depreciation expense on the proposed extension totals

\$28,648. Based upon the Supreme Court of Kentucky's decision regarding depreciation expense on contributed property rendered on November 26, 1986, in the case of, Public Service Commission of Kentucky v. Dewitt Water District, Ky., 720 S.W.2d 725 (1986), the Commission has allowed a total depreciation expense of \$58,328, inclusive of depreciation on contributed property, for rate-making purposes.

Pendleton's test period revenues and expenses have been adjusted as follows:

	<u>Per Staff Report</u>	<u>Adjustments</u>	<u>Test Year Adjusted</u>
Operating Revenues (Includes Miscellaneous Service Revenues)	\$155,581	\$ 11,751	\$167,332
Operating Expenses	<u>154,629</u>	<u>47,951</u>	<u>202,580</u>
Operating Income	\$ 952	\$ <36,200>	\$ <35,248>
Other Income:			
Interest Income	2,297	-0-	2,297
Other Deductions:			
Interest Expense	<u><1,297></u>	<u>-0-</u>	<u><1,297></u>
NET OPERATING INCOME	<u>\$ 1,952</u>	<u>\$ <36,200></u>	<u>\$ <34,248></u>

REVENUE REQUIREMENTS

Pendleton proposed to use a .88 operating ratio to determine total revenue required. The Commission is of the opinion that a Debt Service Coverage ("DSC") of 1.2X the average bond interest and principal payments is more appropriate given Pendleton's capital structure.

Using a 1.2X DSC plus operating expenses, the Commission finds Pendleton's total revenue requirement to be \$265,538.¹ After consideration of test-year interest income of \$2,297, miscellaneous service revenues of \$8,869 and adjusted operating revenue from water sales of \$158,463, an increase in annual revenue of \$95,909 from sales of water will be sufficient. The Commission is of the opinion and finds that the revenue granted herein will produce gross annual revenue sufficient to pay Pendleton's operating expenses, service its debt and provide a reasonable surplus.

CONTINUITY OF ADEQUATE AND RELIABLE SERVICE

The evidence indicates that reliable and adequate service can be maintained throughout the expanded system after completion of the proposed construction. However, there is one area to be served near the proposed water storage tank which could have residual pressure below 30 psig, in violation of 807 KAR 5:066, Section 6 (1). Proctor/Davis/Ray testified that no problems are expected but should complaints be received corrections would be made.

¹	Staff Adjusted Test-Year Operating Expenses		\$202,580
	ADD:		
	Other Interest Expense		1,297
	1.2X (5-Year Average Principal and Interest Requirements)		
	1961 Bonds	\$17,007	
	1977 Bonds	15,570	
	1987 Bonds @ 6 5/8%	18,807	
		<u>\$51,384</u>	
		X 1.2	
			<u>61,661</u>
			<u>\$265,538</u>

FINDINGS AND ORDERS

The Commission, after consideration of the evidence of record, and being advised, is of the opinion and finds that:

1. With the appropriate monitoring of service to potential low pressure areas, public convenience and necessity require that the construction proposed in the application be performed and that a certificate of public convenience and necessity be granted.

2. The proposed construction consists of a 106,000-gallon water storage tank, renovation of the valve vault at the existing elevated water storage tank, approximately 24 miles of 6-inch, and 4-inch diameter pipelines, and related appurtenances. The low bids totaled \$788,580 which will require about \$1,032,750 after allowances are made for fees, contingencies, other indirect costs, and a \$32,750 "Initial Operation and Maintenance Reserve Fund" in accordance with the FmHA letter of conditions.

3. Pendleton should monitor the adequacy of the expanded water distribution system after construction. If the level of service is inadequate or declining, Pendleton should take immediate action to maintain the level of service in conformance with the regulations of the Commission.

4. Any deviations from the construction herein approved which could adversely affect service to any customer should be done only with the prior approval of the Commission.

5. Pendleton should furnish duly verified documentation of the total cost of this project including the cost of construction and all other capitalized costs (engineering, legal, administrative, etc.) within 60 days of the date that construction is

substantially completed. Said construction costs should be classified into appropriate plant accounts in accordance with the Uniform System of Accounts for Water Utilities prescribed by the Commission.

6. Pendleton's contract with Proctor/Davis/Ray should require the provision of full-time resident inspection under the general supervision of a professional engineer with a Kentucky registration in civil or mechanical engineering, to ensure that the construction work is done in accordance with the contract drawings and specifications and in conformance with the best practices of the construction trades involved in the project.

7. Pendleton should require Proctor/Davis/Ray to furnish a copy of the "as-built" drawings and a signed statement that the construction has been satisfactorily completed in accordance with the contract plans and specifications within 60 days of the date of substantial completion of this construction.

8. The financing plan proposed by Pendleton is for the lawful objects within the corporate purpose of its utility operations, is necessary and appropriate for and consistent with the proper performance of its service to the public and will not impair its ability to perform that service and should, therefore, be approved.

9. The financing secured by Pendleton for this project will be needed to pay for the work herein approved. Pendleton's financing plan should, therefore, be approved.

10. The rates proposed by Pendleton would produce revenue in excess of that found reasonable herein and, therefore, should be denied upon application of KRS 278.030.

11. The rates in Appendix A are the fair, just, and reasonable rates for Pendleton in that they are calculated to produce gross annual revenue from water sales of \$254,372. These revenues, along with other miscellaneous service revenues and interest income, will be sufficient to meet Pendleton's operating expenses found reasonable for rate-making purposes, service its debt, and provide a reasonable surplus.

12. A separate Order will be issued in Case No. 9593 regarding the complaint filed by Griffin.

IT IS THEREFORE ORDERED that:

1. Pendleton be and it hereby is granted a certificate of public convenience and necessity to proceed with the proposed construction project as set forth in the drawings and specifications of record herein on the condition that the potential low pressure areas be monitored and corrective action taken in accordance with Finding Numbers 1 and 3 of this Order.

2. Pendleton's financing plan consisting of an FmHA loan of \$273,000 an FmHA grant of \$727,000 and customer connection fees of \$32,750 be and it hereby is approved.

3. If under new FmHA loan conditions Pendleton is notified and granted the option of accepting a lower interest rate at the date of closing, Pendleton shall file with the Commission the FmHA notification of the lower interest rate and shall provide all

correspondence from and to FmHA concerning this notification within 30 days of the closing date.

4. Pendleton shall file a statement of the interest rate accepted from FmHA within 30 days of the date of closing.

5. If Pendleton accepts an interest rate different from the rate approved herein, it shall file amended pages to its bond resolution and an amended amortization schedule.

6. If Pendleton is eligible but does not take advantage of a lower interest rate at the time of closing, it shall fully document why the lower rate was not accepted showing an analysis of the higher costs associated with the loan over its life.

7. Pendleton shall comply with all matters set out in Finding Numbers 4 through 7 as if the same were individually so ordered.

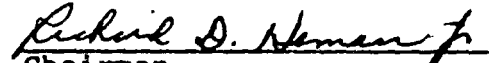
8. The rates proposed by Pendleton are hereby denied.


9. The rates and charges in Appendix A are approved for service rendered by Pendleton on and after the date of this Order.

Nothing contained herein shall be deemed a warranty of the Commonwealth of Kentucky, or any agency thereof, of the financing herein authorized.

Done at Frankfort, Kentucky, this 20th day of April, 1987.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9625 DATED APRIL 20, 1987.

The following rates and charges are prescribed for the customers in the area served by Pendleton County Water District. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

RATES: Monthly

First 2,000 gallons	\$8.25 Minimum Bill
Next 3,000 gallons	3.80 per 1,000 gallons
Next 10,000 gallons	3.70 per 1,000 gallons
Over 15,000 gallons	3.55 per 1,000 gallons

Griffin Industries, Inc.

First 400,000 gallons	\$1,423.40 Minimum Bill
Over 400,000 gallons	3.55 per 1,000 gallons

Pendleton County High School

First 125,000 gallons	\$447.15 Minimum Bill
Over 125,000 gallons	3.55 per 1,000 gallons